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Article · February 2008

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Monetary Exchange Rate Model: Supportive Evidence from Nonlinear Testing Procedures

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11-2-2008

Summary

Using nonlinear testing procedures relevant to the recent literature, this study provides evidence of nonlinear adjustment of nominal exchange rate towards monetary fundamentals in the context of ASEAN-5 countries. While it supports earlier findings supportive of monetary exchange rate model in this region using the linear testing procedures, this study provides insightful information in explaining why persistent misalignments between nominal exchange rate and monetary fundamentals are often observed in the sample data.

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Introduction

The debate on whether or not nominal exchange rates exhibit long-run relationship with the monetary fundamentals has occupied much of international finance researchers' time ever since the break down of the Bretton-Woods system in the mid-1973. To this end, empirical evidence is not as supportive of the monetary model as the theory suggests (see among others, Meese and Rogoff, 1983; Lyons, 2002; Cheung *et al*. 2005). Recently, there is a growing consensus among researchers that the lack of supportive evidence may largely be associated to the negligence of the nonlinear adjustment of exchange rate towards the equilibrium level suggested by the corresponding monetary fundamentals (Taylor and Taylor, 2004). Nonlinearity in exchange rate adjustment is often attributed to the existence of trading frictions such as transaction costs (Dumas, 1992) and menu costs (Chinn, 2001). These trade frictions resulted in a band of inaction whereby exchange rate misalignments which are not large enough to cover arbitrage profit are left uncorrected within the band. Market players take arbitrage advantage only when the misalignments are outside the band. Eventually, misalignments disappear and exchange rate reverts to its mean position suggested by monetary fundamentals. By this principle, deviations of exchange rate from the monetary fundamentals may apparently behave like a random walk locally within the band of inaction, although it is mean-reverting globally.